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High-technology industry developments - 2002/03; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

High-Technology Industry Developments—2002/03

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide auditors with an overview of recent economic, technical, and professional developments that may affect the audits they perform. This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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How This Alert Can Help You

This Audit Risk Alert can help you plan and perform your high-technology industry audits. The knowledge delivered by this Alert can assist you in achieving a more robust understanding of the high-technology business environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

If you understand what is happening in the high-technology industry and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* (product no. 022333kk).

Industry and Economic Developments

The U.S. Business Environment

As of the third quarter of 2002, anxious economists are downgrading their forecasts, and some crucial sectors of the economy are pushing the likelihood of a rebound into next year because of the abrupt slowdown in the economic recovery.

For now, the overall economy is expanding, but sluggishly. Jobs are growing, but barely. And with a depressed stock market, concerns over a possible military action in Iraq, fears of terrorist strikes, and corporate scandals weighing on the national psyche, there is none of the exuberance that marked the recovery in the late 1990s.

The economy appears to be in a struggle between declining business confidence and strong consumer spending. Eventually, consumer demand should overcome business wariness, unless cautious businesses cut so many jobs that consumers finally give up. The same dynamic was at work during the fall of 2001. After September 11, the business sector froze, the consumer sector did not, and eventually consumer demand jump-started the economy.

The underlying economic fundamentals remain relatively sound and point toward a moderate economic growth scenario. However, stock market weakness, coupled with recent data releases, has prompted downward forecast revisions.

Stock Market Woes

Accounting scandals and corporate bankruptcies have generated tremendous investor uncertainty, resulting in a dramatic decline in stock prices. While this is disconcerting, Wall Street scandals are not expected to play a *significant* adverse role in consumer spending or overall economic growth. Furthermore, any negative economic impacts generated by stock price declines are expected by economists to be constrained to third-quarter activity.

Potentially, the decline in stock market prices can affect real economic activity by reducing consumer wealth and by adversely affecting consumer buying attitudes. Both conditions could reduce consumer spending activity.

Stock prices have declined throughout the first three quarters of 2002, resulting in a multitrillion dollar decline in wealth holdings. Most economists believe the decline in wealth will have a relatively small adverse impact on consumer spending. The wealth decline is primarily a temporary paper setback for investors. The underlying economic fundamentals are relatively sound and the profit picture facing corporate America is showing mixed signs of improvement. This suggests that once investors regain confidence in corporate financial reporting, the market will rebound strongly.

Current Monetary Policy

In November 2002, for the first time in 11 months, the Federal Reserve Board lowered the federal funds rate to 1.25 percent, its lowest level in 41 years. At this point the Fed believes that the risks between inflation and very slow economic growth are balanced.

The Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act includes far-reaching changes in federal securities regulation that could represent the most significant overhaul since the enactment of the Securities Exchange Act of 1934. The Act prescribes a system of federal oversight of public auditors through a Public Company Accounting Oversight Board, a new set of auditor independence rules, new disclosure requirements applicable to public companies and insiders, and harsh civil and criminal penalties for persons who are responsible for accounting or reporting violations. The Act also imposes new restrictions on loans and stock transactions involving corporate insiders.

A more complete summary of the Act is available on the AICPA Web site at www.aicpa.org/info/sarbanes_oxley_summary.htm and in the AICPA general *Audit Risk Alert—2002/03*.

General Industry Trends and Conditions

The economy and the stock market have been dominated by the high-technology industry in the past several years. The desire to enter this industry seems unaffected by strong competition and the tragic experience of some of the new high-tech companies that have gone bankrupt.

The pervasive impact of high-technology on our overall economy has been dramatic. It is hard to pick up a newspaper without reading something about the so-called new economy, which is made up of all high-tech sectors. Discussions about the Internet, Web sites, portals, electronic commerce (e-commerce), electronic business (e-business), and dot-com companies abound. Analysts estimate that, over the past several years, technology spending accounted for about 30 percent of the growth in gross domestic product (GDP). In addition, technology has helped to increase productivity, which, in turn, has allowed our economy to grow at such a fast pace for so long without sparking inflation.

However, some analysts now question whether the battered high-technology industry will ever regain its strength. History offers some insight to this question. A decade ago, the U.S. technology industry was left for dead. Asian chipmakers had grabbed nearly half of the global semiconductor market. Personal computers (PCs) were helpful at work but seemed of limited utility elsewhere. Investors didn't see much future and tech companies shrunk to their smallest share of stock market value in 15 years.

But around that same time, a group of engineers at a federal lab in Illinois were writing a small program to make it easier for computer users to navigate the infant World Wide Web through graphical links instead of text-based menus. Their Mosaic program later became Netscape. It changed communications and commerce, and it ignited one of the greatest investment frenzies in history.

Now, the technology industry is again in eclipse. The 100 largest tech companies have lost money in the aggregate for five straight quarters, according to Merrill Lynch & Co. And this time, the high-tech industry's troubles have a wider impact than ever, on both the stock market and the broader economy. Approximately 47 percent of business capital spending goes into tech equipment and software now, compared with 20 percent in 1990. On Wall Street, even after the steep plunge in tech shares, they still account for about 14.5 percent of the value of the Standard & Poor's 500 stock index—nearly twice their share at the bottom of the previous slump.

But three times in the past 25 years, the tech industry has faced downturns and an uncertain future. Each time, new ideas, along with relentless improvements of existing products, brought the industry back to life in unforeseen ways, though some innovations took years to bear fruit. The 1990s boom fed on incremental advances in operating systems and the linking of PCs into office networks. Then, the Internet propelled the industry to unforeseen heights.

What will be the next big thing? One intriguing innovation is Wi-Fi technology, a set of standards created to provide wireless office computer networks. Now it's spreading for an unintended purpose: to deliver Internet access to coffee shops, airports, and homes. Another breakthrough could emerge from the resolution of the thorny legal issues around computerized music and movies. A new generation of cheap sensor chips, all linked to the Internet, could create a boom in technologies that track commerce, machines, and even health.

The biggest test will be the nature and ultimate impact of innovation. Pessimists say they don't see a "killer app" on the horizon. Optimists answer that the next big thing is rarely visible from the depths of a downturn. Products and companies may die, but innovation is a process greater than a series of products.

What Is High Technology and What Are Its Industry Segment Conditions?

It is difficult to find common ground on the precise definition of the high-technology industry. According to the AEA (formerly known as the American Electronics Association), the high-tech industry is made up of 45 Standard Industrial Classification (SIC) codes. These sectors fall into three broad categories—high-tech manufacturing, communications services, and software and computer-related services.

High technology is a lot like quality—people know it when they see it—but it is not easy to define. This means the definition of the high-technology industry varies greatly depending on the combination of products and services selected to define the industry. For the purposes of this Alert, we will use a definition that segments the industry into five classifications—personal computers; semiconductors; mainframes, servers, and storage; networking and telecommunications equipment; and software and services.

Personal Computers

After 25 years of strong growth, the PC industry has reached maturity and its future growth will be determined by economic conditions. According to Computer Industry Almanac, Inc. (CIAI), future PC unit sales growth will remain below 10 percent, and economic recessions will produce PC sales contractions. However, the PC industry will see long-term growth, but year-to-year growth is no longer certain, according to CIAI. PCs-in-use will continue to grow in all regions of the world and will double by 2010 in many regions. PCs-in-use in the United States reached 175 million in 2001 and will pass 300 million by 2010. Worldwide PCs-in-use surpassed 525 million in 2001 and will top 1.1 billion units in 2007.

According to research conducted by CIAI, in 2007 the PC industry will pass another milestone when worldwide PC sales will surpass 200 million units, but this is two years later than was expected in early 2000. Western Europe and North America have the highest PC-adoption rates and consequently will have the slowest growth rates and the highest risk for PC sales declines during economic downturns. Annual PC sales now depend much more on replacement sales than sales to new customers. This means that the economic life of the average PC will become the largest factor in determining annual PC unit sales.

Short product life cycles are a fundamental characteristic of this industry sector. For example, the life cycle of a desktop PC is thought to be two years or less, and it is estimated that up to 50 percent of profits for PCs and related products are generated in the first three to six months of sales. As a result, computer makers face the risk of inventory obsolescence. (See the "Inventory Valuation" section later in this Alert for a discussion of this issue.)

Computer manufacturers may enter into hedging transactions to protect themselves from fluctuating prices of the components used in the production of computers. As a result, computer manufacturers may be affected by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Semiconductors

The worldwide semiconductor market is forecast to post double-digit growth in 2003, with revenue totaling $171.8 billion, a

12.1 percent increase from 2002 estimates, according to Dataquest Inc., a unit of Gartner, Inc.

In 2001, worldwide semiconductor revenue totaled $152.5 billion, a 32 percent decline from 2000. In 2002, the market is beginning to see signs of recovery, as revenue is projected to reach $153.3 billion, a 0.5 percent increase from 2001.

The semiconductor market recovery in 2002 has progressed as expected, with strong growth in the first half of 2002 as inventories were replenished, and weaker growth in the second half of the year, according to analysts with Gartner Dataquest's semiconductor research group. Although semiconductor sales in the third quarter of 2002 held up reasonably well, benefiting from a degree of seasonal strength, that strength has not carried forward into the fourth quarter and highlights the poor state of electronic equipment production.

The worldwide digital cellular handset market is one of the few bright spots in the semiconductor industry and is driven primarily by a replacement cycle as the industry shifts from second generation (2G) to 2.5 generation (2.5G) cellular, which is good news for semiconductor vendors because it increases demand for silicon-rich handsets.

Gartner Dataquest analysts said that while PC unit production growth has stalled in 2002, a corporate PC replacement cycle is becoming overdue and cannot be put off much longer. A broader-based recovery in electronic equipment production, especially in the wired communications segment, is unlikely to begin until 2004, suggesting a limited impact on semiconductor sales in 2003. 2003 is forecast to be a transition year, as a phased recovery in end markets gradually works its way back to fuel incremental semiconductor sales growth.

In this sector of the industry, where rapid replacement of capital assets is common, you may need to ensure that your clients have appropriately considered the provisions of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. (See the "Asset Impairment" section later in this Alert for further discussion on this topic.)

Another implication for the shifting needs of product manufacturers and end users is the potential for rapid inventory obsolescence. New types of chips are continuously developed, quickly rendering older ones obsolete. Product life cycles continue to decrease, and communications protocols constantly change. As a result, you may need to consider an increased level of risk associated with inventory valuations. (For a further discussion, see the section titled "Inventory Valuation" later in this Alert.)

Mainframes, Servers, and Storage

The worldwide server market grew 3.1 percent in the third quarter of 2002, as worldwide server shipments totaled 1.1 million, up from 1.07 million units in the third quarter of 2001, according to Dataquest Inc., a unit of Gartner, Inc. While the industry did grow, Gartner Dataquest analysts said the relatively poor performance of the market for the same quarter last year, due primarily to the terrorist attacks of September 11, must be considered when judging the change.

The performance of the worldwide server market in the third quarter of 2002 should be interpreted with caution because of the issues that existed in the same quarter one year ago. The server market still looks cloudy, with the possibility of war in the Middle East further aggravating economic uncertainty, and continued constraints on information technology (IT) spending that make it hard to be optimistic about real recovery of the worldwide server market this year.

The United States server market continued to show signs of recovery, with a 12.2 percent increase in the third quarter of 2002, and shipments of 488,858 units, up from 435,620 in the third quarter of 2001.

As with other segments of the high-tech industry, there is the potential for rapid inventory obsolescence. As demand for new types of servers and storage systems increases, older types may become obsolete. As a result, you may need to consider an increased level of risk associated with inventory valuations. (For a further discussion, see the section titled "Inventory Valuation" later in this Alert.)

Networking and Telecommunications Equipment

The international market for telecommunications equipment and services grew 11.1 percent last year, reaching nearly $1.2 trillion, according to research by the Telecommunications Industry Association (TIA).

Growth in the Mexican and Canadian markets was slow in 2001 as a result of the weakening economic climate in both countries, and the pace is expected to continue through the rest of this year. By 2003, however, a fully recovered economy will make room for double-digit increases in equipment spending. Spending on enterprise equipment will propel this growth with an expected increase of $5.3 billion between 2001 and 2005, reaching $16.8 billion. Spending on public network equipment will grow from $5.5 billion in 2001 to $8 billion in 2005.

In Western Europe, telecommunications infrastructure and enterprise equipment spending fell 11.5 percent, with enterprise equipment dropping 9 percent and public network equipment seeing a sharp decline of 19.2 percent in 2001. TIA predicts the equipment market will begin to pick up in 2002, and enterprise equipment spending is projected to grow at a 5.4 percent combined annual growth rate (CAGR) through 2005.

In Eastern Europe, enterprise equipment and public network spending are projected to grow at nearly equal rates. Enterprise spending will grow at a 10.4 percent CAGR, reaching $17.5 billion in 2005, up from $11.8 billion in 2001. Public network equipment spending will increase at a 9.2 percent CAGR over the same period, rising from $3.3 billion to $4.7 billion.

Enterprise spending in Latin America is gaining ground on public network equipment spending. The latter will grow at a projected 8.8 percent compound annual rate during the 2001-through-2005 study period, compared to 9.3 percent expected growth compounded annually for enterprise equipment.

A surge in demand for network infrastructure will dominate growth in the Asia-Pacific markets through 2005, predicts TIA. For the 2001-through-2005 study period, public network equipment spending will grow at a projected 17 percent CAGR to $36.6 billion, and enterprise equipment spending will advance at 11.5 percent CAGR to $122 billion.

A jump in fiber spending is expected to come despite the recent economic downturn and a perceived excess of capacity in the network that caused an overall 13.8 percent decrease in carrier equipment expenditures to $41 billion in 2001. Service provider purchases are projected to decrease 10.8 percent to $36.5 billion in 2002, but the negative trend is beginning to turn, heralding positive growth in 2003.

In the meantime, strong enterprise demand for bandwidth-hungry applications is driving the broadband market and reducing the current supply. Continuing a trend from 2000, the most immediate growth in carrier spending will be found in the related gear to get more out of existing fiber. New generations of optical switches and signaling gateways have proven their ability to streamline data transmission time and use less power, thus making fiber more affordable and easier to upgrade. Furthermore, some of the new optical switches that require later generations of fiber will offer such efficiencies that service providers will find it more cost-effective to lay additional fiber in the months ahead, rather than retrofit current network plant.

Software and Services

The continued economic slump in business capital spending is changing the shape of the software industry as top-tier software vendors are gaining revenue share at the expense of the pure-play vendors, according to Dataquest Inc., a unit of Gartner, Inc.

Dataquest analysts refer to these top-tier vendors as titan vendors (vendors that have achieved dominant market share in more than one software market segment by offering a diversified and often integrated line of software products). Pure-play vendors derive most of their software revenue from the sale of products within one market. The realities of the weak economy continue to shift the competitive advantage from pure-plays to titans.

Software titans have deeper pockets and can withstand the economic challenges much easier than many pure-play vendors, which have smaller revenue streams and cash reserve, according to analysts with Gartner Dataquest's Software Industry Research group. This has caused struggling pure-play vendor solutions to be less desirable from a financial perspective, even though they can be a better solution to risk-averse decision makers. Loss of revenue, partly because of such reluctance in the marketplace, may indeed make bankruptcy or acquisition by a titan a self-fulfilling prophecy.

Worldwide end-user spending on software is forecast to grow 3.6 percent in 2002, with revenue of $76.9 billion, and increase to $81.8 billion in 2003. In 2001, worldwide software revenue declined 5.7 percent, with revenue of $74.2 billion.

The first-half 2002 license revenue performance of enterprise software companies was lackluster because of the continued bad news concerning the U.S. and global economy that is inhibiting corporate purchases and stalling investment decisions.

Tight IT budgets have meant that buyers cannot satisfy their pent-up demand for software projects to improve corporate business performance and IT infrastructure efficiencies. When budgets loosen in the second half of 2003 or the first half of 2004, the backlog of demand could cause a temporary growth surge that then settles down to normal growth rates.

Other Economic and Regulatory Issues

Broadband

Leading high-technology associations, banded together as members of the High Tech Broadband Coalition (HTBC), say that swift action by the Federal Communications Commission (FCC) to achieve a minimal regulatory environment is needed to help speed broadband deployment and create an economic rebound for the technology and telecommunications industries. HTBC is an ad hoc alliance of the leading trade associations of the computer, telecommunications equipment, semiconductor, consumer electronics, software, and manufacturing sectors committed to the rapid and ubiquitous deployment of fast, interactive, content-rich, and affordable broadband services.

HTBC argues the broadband services market is distinct from the legacy voice market and has urged the FCC to refrain from imposing Section 251 unbundling obligations on incumbent local exchange carriers' (ILEC) new, last-mile broadband facilities, including fiber and DSL and successor electronics deployed on the customer side of the central office, used to provide broadband services. HTBC believes removal of these antiquated and burdensome regulations will produce the economic incentive needed for increased investment in broadband, facilities-based competition.

President Bush and members of Congress acknowledge that hurdles and barriers could be standing in the way of broadband reaching its promise of revitalizing the national and global economy. The high-tech industry believes strongly that one important component of a broadband policy or strategy is ensuring that the regulatory framework fosters an environment that encourages all broadband competitors to upgrade, expand, and innovate across the wide variety of existing and future communications networks capable of supporting broadband services.

Audit Issues and Developments

Assessing Audit Risks in the Current Environment

The proper planning and execution of an audit has always required you to have a thorough understanding of the high-tech industry and the nature of your client's business. For most audit firms, this in-depth understanding means that the most experienced partners and managers must become involved early and often in the audit process. In today's high-tech environment, your judgment, knowledge, and experience are even more important than they were in the past.

During the past year, the U.S. economy has suffered some significant declines: consumer confidence has dropped, plant closings and layoffs have increased dramatically, profit margins for many companies have slipped, and many companies have failed.

Periods of economic uncertainty lead to challenging conditions for companies attributable to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. During such times, professional skepticism should be heightened and the status quo should be challenged.

More specifically, in today's economic environment, you should keep the following points in mind as you plan and perform audits of high-tech clients.

- Understand how your client is affected by changes in the current business environment.
- Understand the stresses on your client's internal control over financial reporting, and how they may affect its effectiveness.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, notwithstanding prior experiences with or belief in management's integrity.
- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.
- Make management aware of identified audit differences on a timely basis.
- Question the unusual and challenge anything that doesn't make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a "gray" area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

Specific points to keep in mind with respect to high-tech clients include:

- Consider the inappropriate use of "bill and hold" accounting, for example, in circumstances where the customer has not requested the delay in shipment or provided a ship date that is unreasonably long in the circumstances.
- Identify "round trip" transactions (see the "Accounting Issues and Developments" section later in this Alert for a detailed discussion of these transactions).
- Consider nonmonetary transactions.
- Pay attention to whether persuasive evidence of the arrangement exists at the time revenue is recognized and whether legal title to the goods has been transferred and the customer has all the risks and rewards of ownership at that time.
- Consider customers' rights of return, particularly those of distributors, and whether all the requirements of FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, have been satisfied for revenue recognition.

Professional Skepticism

The third general audit standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence. Although you neither assume that management is dishonest nor assume unquestioned honesty, you should consider the increased risk associated with the potential increases in external pressure faced by management during the current economic climate.

As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or through changes in the method of calculating key estimates, such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. Material nonrecurring transactions may require special disclosure to facilitate the readers' understanding of the reported financial results, and the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, should be applied in reporting the effects of changes in estimates. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements might include premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable (whether within a range or at a point), and failure to record unpaid purchase invoices. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or audit committee, and with transaction counterparties.

Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

- Liquidity matters
  - The company is undercapitalized, is relying heavily on bank loans and other credit, and is in danger of violating loan covenants.
  - The company appears to be dependent on an initial public offering for future funding.
  - The company is having difficulty obtaining or maintaining financing.
  - The company is showing liquidity problems.
- Quality of earnings
  - The company is changing significant accounting policies and assumptions to less conservative ones.
  - The company is generating profits, but not cash flow.

- Management characteristics
  - Management's compensation is largely tied to earnings or the appreciation of stock options.
  - The company appears vulnerable to the weakening economic conditions, and management is not proactive in addressing changing conditions.
  - The company's management is selling their investment in company securities more than in the past.
  - There is a significant change in members of senior management or the board of directors.

Auditing Estimates

The high-tech industry uses estimates in a variety of ways. For example, both the recognition and measurement of impairment losses require management to make estimates of future events or assumptions about current conditions.

When auditing estimates, you should be familiar with Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342); the AICPA Practice Aid, *Auditing Estimates and Other Soft Information*; and Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Currently, most segments of the high-tech industry are in decline. Certain estimates, for example, expected future cash flows used in the determination of possible asset impairment, require management to make assumptions about future events and conditions. Be skeptical of cash flow and other performance projections that assume overly optimistic upward trends will occur.

Pay close attention to the underlying assumptions used by management when auditing accounting estimates. Management is responsible for making the estimates included in the financial statements. Those estimates may be based in whole or in part on subjective factors such as judgment based on experience about past as well as current events and about conditions it expects to exist. You should be alert to the possibility of management's over-reliance on economic information based on favorable conditions to predict future outcomes.

Unusual Transactions

Among the most frequently cited sources of financial reporting risk are significant adjustments or unusual transactions occurring at or near the quarter end or year end. Unusual transactions might include sales of assets outside the ordinary course of business, significant or unusual period-end revenues, introduction of new period-end sales promotion programs, and disposal of a segment of a business. These types of transactions and adjustments often occur outside the company's ordinary course of business and, therefore, may not be subject to the checks and balances imposed by the internal control system.

Key points include:

- Recognizing the underlying business purpose for entering into unusual transactions, as well as the resulting financial benefits or obligations.
- Whether unusual transactions—particularly those executed close to period end—are subject to effective controls.
- The impact of these types of transactions on annual and quarterly results, and whether they have been appropriately described in the company's financial reports.
- Existence of any "special" or "side" arrangements not considered in determining the appropriate accounting and disclosure for the transactions.
- Whether so-called nonstandard journal entries, including the adjusting entries made at the end of the closing process, are subject to appropriate review and oversight.

Consideration of Fraud

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides the primary guidance on your responsibilities for detecting fraud-related misstatements when performing a financial statement audit.[1] SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

Some examples of fraud risk factors that may exist in high-tech entities include the following:

- The use by management of unusually aggressive accounting practices in recognizing revenue.
- Complicated criteria for recognizing sales transactions, making it difficult to assess the completion of the earnings process. (For additional information about revenue-recognition-related issues, see the "Revenue Recognition" section of this Alert.)
- Inadequate responses or an unwillingness to respond to inquiries about known regulatory or legal issues.
- Significant related-party transactions.
- A significant portion of management compensation represented by bonuses, stock options, or other incentives.
- Excessive interest by management in maintaining or increasing an entity's stock price.

The general state of the recent economy may raise several fraud risk factors. For example, management may be under significant pressure to obtain additional capital, or the entity may depend on debt with debt covenants that are difficult to maintain under the circumstances.

SAS No. 99 also identifies risk factors related to misstatements arising from fraudulent financial reporting, such as a high degree

1 Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*; amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). See the discussion of this new SAS in the "New Auditing and Attestation Pronouncements and Other Guidance" section later in this Alert.

of competition or market saturation and rapidly changing technology or rapid product obsolescence. All of these factors are present in the high-tech industry, implying potential audit concerns.

Evaluating Going Concern

A number of high-tech industry sectors have experienced intense competition, recurring operating losses, negative cash flows, and the inability to obtain debt or equity financing. These factors have resulted in a high rate of business failure. The current business environment and market conditions might lead to rapidly deteriorating operating results and liquidity challenges for some high-tech companies, particularly those with reduced access to capital. A company particularly sensitive to negative changes in economic conditions can rapidly develop a liquidity crisis and ultimately fail.

Certain conditions, considered in the aggregate, may lead you to question the entity's ability to continue as a going concern. In general, conditions and events that might indicate caution about going-concern issues could include (1) negative trends, such as recurring operating losses; (2) financial difficulties, such as loan defaults or denial of trade credit from suppliers; (3) internal challenges, such as substantial dependence on the success of a particular product line or service; or (4) external matters, for example, disaster occurrences such as the attacks of September 11, pending legal proceedings, or loss of a principal supplier. Also consider the case of an entity's excessive and unusual reliance on external financing, rather than on money generated from the company's own operations as a going-concern issue.

Key in evaluating these risk factors is whether:

- Existing conditions and events can be mitigated by management's plans and their effective implementation.
- The company has the ability to control the implementation of mitigating plans rather than depending on actions of others.
- The company's assumption about its ability to continue as a going concern is based on realistic, rather than overly op-

timistic, assessments of its access to needed debt or equity capital or its ability to sell assets in a timely manner.

- Liquidity challenges have been appropriately satisfied and disclosed.

When evaluating management's plans to continue as a going concern, an appropriate level of professional skepticism is important. For example, you may want to scrutinize the company's assumptions to continue as a going concern to assess whether those assumptions are based on overly optimistic or "once-in-a-lifetime" occurrences.

Key factors in your evaluation of the ability to continue as a going concern are part of the guidance provided in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341).

Auditor's Responsibilities Related to a Going-Concern Issue

Auditors should be aware of their responsibilities pursuant to SAS No. 59 (AU sec. 341.02 and .03b). That statement provides guidance about conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS) to evaluate whether there is substantial doubt about a client's ability to continue as a going concern for a reasonable period of time.

Continuation of an entity as a going concern is generally assumed in the absence of significant information to the contrary. Information that significantly contradicts the going-concern assumption, or the ability to remain a going concern, relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. SAS No. 59 does not require you to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

If there is substantial doubt about the entity's ability to continue as a going concern, you should consider whether it is likely that management plans can mitigate existing conditions and events and whether those plans can be effectively implemented. If you obtain sufficient competent evidential matter to alleviate doubts about going-concern issues, you should give consideration to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, you conclude that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, refer to the specific guidance set forth under SAS No. 59.

Businesses in Bankruptcy Reorganization

For those high-tech entities or operations that are under bankruptcy reorganization pursuant to Chapter 11 of the Bankruptcy Code, or are emerging from it, consider whether the company is following the accounting guidance of SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. Entities that filed for bankruptcy may have impairments that need to be recorded before fresh-start accounting under SOP 90-7.

Related-Party Transactions

One of the more important, and yet more difficult, aspects of a financial statement audit is the identification of related parties and transactions with related parties. This aspect of the audit is important because of (1) the requirement under GAAP to disclose material related-party transactions and certain control relationships, (2) the potential for distorted or misleading financial statements in the absence of adequate disclosure, and (3) the instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an undisclosed related party. See the AICPA general *Audit Risk Alert—2002/03* for an in-depth discussion of related-party transactions.

Inventory Valuation

The primary literature on inventory accounting is Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapters 3A and 4, which provide the following summary:

> Inventory shall be stated at the lower of cost or market, except in certain exceptional cases when it may be stated above cost. Cost is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in, first-out; average; and last-in, last-out).

Whether inventory is properly stated at lower of cost or market can be a very significant issue for high-technology audit clients because of the rapid changes that can occur in many areas of the industry, and the need for entities to keep up with the newest technology. Examples of factors that may affect inventory pricing include:

- Changes in a product's design that may have an adverse impact on the entity's older products, with older products not as salable as the newer versions.
- A competitor's introduction of a technologically advanced version of the product that may decrease salability of a client's products.
- Changes in the products promoted by the industry as a whole, such as a shift from analog to digital technology, that may affect salability.
- Changes in foreign economies that could result in such situations as slowdown of sales to that region or lower-priced imports from that region.
- Changes in technology to produce high-technology products that can give competitors a selling-price advantage.
- Changes in regulations that could affect the competitive environment.

- The entity's own product changes that may not be well researched due to the pressure to introduce new products quickly, resulting in poor sales or high returns.

The highly competitive environment and the rapid advancement of technological factors contribute to the common problem of rapid inventory obsolescence in the high-technology industry. As such, you should consider whether the carrying amount of inventories is appropriate.

You can look at many factors in determining the proper valuation of inventories. A few examples of factors that may be useful include the following:

- Product sales trends and expected future demand
- Sales forecasts prepared by management as compared with industry statistics
- Anticipated technological advancements that could render existing inventories obsolete or that could significantly reduce their value
- Inventory valuation ratios, such as gross profit ratios, inventory turnover, obsolescence reserves as a percentage of inventory, and days' sales in inventory
- New product lines planned by management and their effects on current inventory
- New product announcements by competitors
- Economic conditions in markets where the product is sold
- Economic conditions in areas where competitive products are produced
- Changes in the regulatory environment
- Unusual or unexpected movements, or lack thereof, of certain raw materials for use in work-in-process inventory
- Levels of product returns
- Pricing trends for the type of products sold by the client

- Changes in standards used by the industry

These are not the only issues of importance to consider. You may need to address many other issues, including the client's taking of physical inventories in high-technology entities. Consider guidance set forth in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 331.09-.13, "Inventories"). Among the issues for your consideration are the following:

- When dealing with some difficult types of inventory, such as chemicals used in the process, you may need to take samples for outside analysis. The work of a specialist may also be needed, and in this case you should follow the guidance set forth in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).
- The extent to which raw materials have been converted to work-in-process will need to be determined to assess the value of the work-in-process.
- Indications of old or neglected materials or finished goods need to be considered in the valuation of the inventory.
- The client's inventory held by others, as well as field service inventories for use in servicing the client's products, will need to be considered.

In addition, the SEC staff believes that inventory reserves create a new cost basis and thus cannot be subsequently reversed into income as a change in estimate if, for example, demand were forecasted to pick up and thereby a previously established excess and obsolete inventory reserve were deemed no longer necessary.

There are also risks posed by the use of contract manufacturers. In many of those circumstances the hardware vendor will provide the contract manufacturer with a guarantee against its loss due to excess raw material inventory (and, possibly, against the value added in the manufacturing or assembly process) that would occur if the vendor were to reduce purchases beyond a certain point. Such a guarantee may represent a contingent loss that needs to be recognized or disclosed under FASB Statement No. 5, *Accounting for Contingencies*. The disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*, also need to be considered.

Revenue Recognition

Revenue recognition continues to pose significant audit risk to auditors. The high-technology industry represents one of the more challenging industries when it comes to the topic of revenue recognition.

Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, summarizes the SEC staff's views in applying GAAP to selected revenue recognition issues. SAB No. 101 presents various fact patterns, questions, and interpretive responses concerning whether the following criteria of revenue recognition are met:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

Another SEC publication, *SAB No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, addresses recurring questions from preparers, auditors, and analysts about how to apply the guidance in SAB No. 101 to particular transactions.

SAB No. 101 reflects the basic principles of revenue recognition in GAAP and does not supersede any existing authoritative literature. Accordingly, while SAB No. 101 is directed specifically to transactions of public companies, management and auditors of nonpublic companies may find the guidance helpful in analyzing revenue recognition matters.

The SEC continues to see instances of questionable and inappropriate revenue recognition practices. Significant issues encountered recently include:

- Complex arrangements that provide for separate, multiple deliverables (for example, multiple products and/or services), at different points in time, during the contract term.
- Nonmonetary (for example, barter) transactions where fair values are not readily determinable with a sufficient degree of reliability.

The SEC has requested that the Emerging Issues Task Force (EITF) address certain of these issues to clarify the application of GAAP in these transactions. However, the SEC staff generally believes that the existing accounting literature provides analogous guidance for a number of these issues, including SOP 97-2, *Software Revenue Recognition*; APB Opinion No. 29, *Accounting for Nonmonetary Transactions*; SOP 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts*; FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*; and FASB Concept Statement No. 6, *Elements of Financial Statements*.

AICPA's Audit Guide on Revenue Recognition

The AICPA Audit Guide, *Auditing Revenue in Certain Industries*, assists auditors in auditing assertions about revenue in selected industries not covered by other AICPA Audit and Accounting Guides. You can look to this Guide for descriptions and explanations of auditing standards, procedures, and practices as they relate to auditing assertions about revenue in both the computer software and high-tech manufacturing industries.

This Guide:

- Discusses the responsibilities of management, boards of directors, and audit committees for reliable financial reporting.
- Summarizes key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP.
- Identifies circumstances and transactions that may signal improper revenue recognition.

- Summarizes key aspects of the auditor's responsibility to plan and perform an audit under GAAS.
- Describes procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition.

Help Desk—You may order AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk) from the AICPA at (888) 777-7077 or go online at www.cpa2biz.com.

Auditing in a Paperless Environment

When clients rely on technology to manage and analyze information, audit strategies change. Consider the following examples:

- Audit evidence that previously existed in paper form may be available electronically only. Accessing electronic audit evidence may require you to become proficient in the use of data-extraction or other audit software tools.
- The design and operation of internal control in a computer environment is much different than in a predominately manual environment.

As companies continue to expand their use of IT, you may need to become aware of the unique audit issues in a highly computerized environment. In addition, you should identify the risks of material misstatement that can arise during the transition from a highly manual environment to a more computerized operating environment.

For further information and guidance on auditing in this paperless environment, see SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and SAS No. 80, *Amendment to SAS No. 31,* Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326).

How Employee Layoffs Might Affect Your Engagements

Many companies continue to experience layoffs during the recent economic downturn. The layoff trend is broad based, affecting not only industries that were racing ahead until recent months, such as technology and telecommunications entities, but also businesses once thought to be recession-proof, for example, food and consumer products. Healthy companies are also using layoffs as a tool to reduce costs and accumulate earnings as they maneuver through this economic downturn. What do layoffs imply for you as you plan your engagements?

If your high-technology clients are experiencing, or have experienced, layoffs, they will need to properly account for employee-related termination charges, such as severance package charges, restructuring charges, and voluntary separation charges. In addition, management may need to properly account for outplacement services offered to their departing employees and bonuses and educational allowances offered to assist employees in contending with the loss of their jobs. Here we offer some highlights of the accounting literature and other topics related to terminations to help provide guidance regarding issues related to layoffs.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, addresses the timing of liability recognition for certain employee termination benefits in addition to the financial statement disclosures that should be made for those charges.[2]
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 through 14 for guidance on curtailment and paragraphs 15 through 17 for guidance on termination benefits.

2 EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, will be superseded upon the effective date of FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. See the "New Accounting Pronouncements and Other Guidance" section of this Alert for a discussion of this pronouncement.

- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, requires recording as a loss the effect of curtailment, for example, termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business. Refer to paragraphs 96 through 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.

- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, an amendment of FASB Statements No. 5, *Accounting for Contingencies*, and No. 43, *Accounting for Compensated Absences*, requires that entities providing postemployment benefits to their former or inactive employees accrue the cost of such benefits. Accrual would occur in accordance with FASB Statement No. 5, *Accounting for Contingencies*, when four conditions are met. Inactive employees include those who have been laid off, regardless of whether they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and continuation of benefits, such as health care benefits and life insurance coverage.

  FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. The financial statement shall disclose if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures only (that is, not measurement or recognition) and standardizes the disclosure requirements for pensions and other postretirement benefits. Among other disclosures, the Statement requires the disclosure of the amount of any gain or loss recognized due to a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event are required to be disclosed.

- SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560, "Subsequent Events"), describes matters related to subsequent events. Use this guidance as you inquire of and discuss with the management matters involving unusual terminations of participants, such as terminations arising from a sale of a division or layoffs, in addition to other matters.

- Significant layoffs can have a serious effect on an entity's internal control structure and financial reporting and accounting systems. Employees who remain at the company may feel overwhelmed by their workloads, may have insufficient time to complete their tasks completely and accurately, and may be performing too many tasks and functions. With additional workloads and requirements for the performance of added tasks, the company might experience challenges to maintaining an adequate segregation of duties in addition to other experiences affecting internal control.

- The auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have experienced strong financial reporting and accounting controls before layoffs could see those controls deteriorate due to the lack of employees and to redefined employee tasks.

Consider these issues related to employee layoffs when you plan and perform the audit and you assess control risk. Remember that gaps in key positions, and other changes related to reorganization or release of employees, may cause control weaknesses representing reportable conditions that you should communicate to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended. Also see SAS No. 55, *Consideration of Internal Con-*

trol in a Financial Statement Audit (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, which can help provide a framework to help the auditor obtain an understanding of internal control.

Accounting Issues and Developments

IRU Capacity Swaps

The SEC staff has communicated to the SEC Regulations Committee the following staff position regarding indefeasible right to use (IRU) capacity swaps.

The SEC staff has concluded that all IRU capacity swaps consisting of the exchange of leases should be evaluated within paragraph 21 of APB Opinion No. 29. That is, if a swap involves leases that transfer the right to use similar productive assets, the exchange should be treated as the exchange of similar productive assets, irrespective of whether the "outbound" lease is classified as a sales-type lease, direct financing lease, or operating lease and irrespective of whether the "inbound" lease is classified as a capital lease or an operating lease. The staff believes that the lease classification criteria of FASB Statement No. 13, *Accounting for Leases*, are not an appropriate basis for an entity to "filter" a determination of whether the exchange involves similar productive assets. This conclusion is based on the thought that the right to use an asset—that is, a lease—is in fact an asset and not a service contract, irrespective of whether such asset is recognized in a company's balance sheet.

This conclusion would require that IRU capacity swaps involving the exchange of leases be recognized based on the carrying value of the assets exchanged, rather than on fair value. The staff did point out that exchanges involving sufficient boot would still be treated as part monetary and part nonmonetary per EITF Issue No. 01-2, *Issues Related to the Accounting for Nonmonetary Transactions*.

The staff expects that registrants will apply this guidance historically to IRU capacity swap transactions that occurred in prior years and, if appropriate, restate their financial statements. The chief executive officer and chief financial officer should be advised to give consideration to this matter before certifying the financial statements previously filed with the SEC.

Revenue Recognition

Income Statement Classification

The appropriate classification of amounts within the income statement or balance sheet can be as important as the appropriate measurement or recognition of such amounts. In the current environment where revenue growth may not be as robust as originally projected, the auditor needs to be particularly concerned about income statement misclassifications designed to increase reported revenue (for example, reporting agency transactions on a gross basis and showing sales discounts as a marketing expense rather than a revenue reduction). Several EITF consensus provisions provide guidance on the proper classification of certain revenue and expense items. For example, consider EITF Issues No. 99-17, *Accounting for Advertising Barter Transactions*; No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*; No. 00-10, *Accounting for Shipping and Handling Fees and Costs*; and No. 00-14, *Accounting for Certain Sales Incentives*; all of which were to be applied no later than in the December 31, 2000, financial statements for calendar year-end companies. SEC registrants should apply the guidance provided in SEC Regulation S-X regarding classification of amounts in financial statements.

Round Tripping

Round tripping is another a technique used to artificially inflate revenues and has appeared in several restatement scenarios. It involves transactions in which the company sells products and services to the same entity from which it buys products and services. Often the transactions happen in close temporal proximity and completing one transaction is dependent on completing the other. The fair value of both transactions may be overstated such that the company can report higher revenue at the "cost" of increased expenses. In addition, the products and services purchased back may not be used in the same period the revenue is recognized, resulting in more than a basic incorrect grossing-up of the income statement.

Vendor Financing

The reduced liquidity of many customers is resulting in an increased use of vendor financing that goes well beyond normal trade terms. That requires consideration of whether the fee is fixed or determinable and/or collectible. In addition, provisions of APB Opinion No. 21, *Interest on Receivables and Payables*, need to be considered.

Nonmonetary or Barter Transactions

Abuses in the area of nonmonetary or barter transactions have also been a focus of several recent restatements. The principal issues are whether there is a legitimate business purpose for the transaction and whether there is sufficient objective evidence of fair values. Also of concern is "disguised" barter transactions that are not analyzed as such due to the presence of "boot" or separation in time of transactions that are, in fact, negotiated together. Abuses are seen most often in situations where there is little hard inventoriable cost associated with the deliverables.

Business Combinations

In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, to address financial accounting and reporting issues for business combinations. This Statement supersedes APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*.

Under FASB Statement No. 141, all business combinations will be accounted for using one method—the purchase method. Given the economic environment of the high-technology industry, mergers and acquisitions have been, and continue to be, prevalent. Therefore, this change to a single method of accounting for business combinations may have major implications for high-tech companies.

Under APB Opinion No. 16, business combinations were accounted for using one of two methods: the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods, producing dramatically different results.

The provisions of FASB Statement No. 141 reflect a fundamentally different approach to accounting for business combinations. The single-method approach reflects the conclusion that virtually all business combinations are acquisitions and, thus, all business combinations should be accounted for in the same way that other asset acquisitions are accounted for—based on the values exchanged. Specifically, FASB Statement No. 141 changes the accounting for business combinations in APB Opinion No. 16 in the following respects:

- FASB Statement No. 141 requires that all business combinations be accounted for by a single method—the purchase method.
- In contrast to APB Opinion No. 16, which required separate recognition of intangible assets that can be identified and named, FASB Statement No. 141 requires that intangible assets be recognized as assets apart from goodwill if they meet one of two criteria—the contractual-legal criterion or the separability criterion.
- In addition to the disclosure requirements in APB Opinion No. 16, FASB Statement No. 141 requires disclosure of the primary reasons for the business combination and of the allocation of purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption.

The provisions of FASB Statement No. 141 apply to all business combinations initiated after June 30, 2001. The Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. (See the "New Accounting Pronouncements and Other Guidance" section of this Alert for additional information related to this standard.)

Goodwill and Other Intangible Assets

The FASB issued FASB Statement No. 142, *Goodwill and Other Intangible Assets,* in June 2001. This Statement supersedes APB Opinion No. 17, *Intangible Assets,* and addresses how to account for intangible assets that are acquired individually or with a group of other assets upon their acquisition. This Statement also addresses how to account for goodwill and other intangible assets after they have been initially recognized in the financial statements. The nature and activities of the high-technology industry lend importance to this new standard. Be aware of its guidelines, especially regarding your high-technology clients.

FASB Statement No. 142 changes the unit of account for goodwill and takes a very different approach to how to account for goodwill and other intangible assets subsequent to their initial recognition. Because goodwill and some intangible assets will no longer be amortized, the reported amounts of goodwill and intangible assets will not decrease at the same time and in the same manner as under previous standards. Specifically, FASB Statement No. 142 changes the subsequent accounting for goodwill and other intangible assets in the following respects:

- FASB Statement No. 142 adopts a more aggregate view of goodwill and bases the accounting for goodwill on the units of the combined entity into which an acquired entity is integrated. Those units are referred to as reporting units.
- APB Opinion No. 17 presumed that goodwill and all other intangible assets were wasting assets (that is, finite lived). FASB Statement No. 142 does not presume that those assets are wasting assets. Instead, goodwill and other intangible assets that have indefinite useful lives will not be amortized but, rather, will be tested at least annually for impairment.
- FASB Statement No. 142 provides specific guidance for testing goodwill for impairment. The annual test for goodwill impairment uses a two-step process that begins with an estimation of the fair value of a reporting unit. However, if certain criteria are met, the requirement to test

goodwill for impairment annually can be satisfied without a remeasurement of the fair value of the reporting unit.

The provisions of FASB Statement No. 142 are required to be applied starting with fiscal years beginning after December 15, 2001. This Statement is required to be applied to all goodwill and other intangible assets recognized in the financial statements at that date. Goodwill and intangible assets acquired after June 30, 2001, will be subject immediately to the nonamortization provisions of FASB Statement No. 142.

Because there have been numerous combinations of high-tech companies in recent years, and because goodwill may represent a significant asset on the balance sheets of these combined companies, you should carefully consider the impact of any such change on your high-tech clients. Specifically, such a change will necessitate the need to identify the reporting units of the organization and test for impairment of goodwill at the reporting unit level. This process will require extensive valuation judgments and calculations.

A valuable tool to use when auditing or valuing intangibles is the AICPA Practice Aid *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (product no. 006609kk).

Recent EITF Issues and AICPA TPAs Relevant to the High-Tech Industry

Auditors of high-tech companies should pay close attention to EITF issues and AICPA Technical Practice Aids (TPAs) because in the past several years the EITF and the AICPA addressed a number of topics relevant to the high-technology industry.

The application of EITF consensus positions (category c of the GAAP hierarchy) effective after March 15, 1992, is mandatory under SAS No. 69, *The Meaning of* Present Fairly in Accordance With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended.

TPAs bring together for continuing reference selected technical questions and answers (nonauthoritative), SOPs (accounting as well as auditing and attestation), AcSEC Practice Bulletins, a list of Issues Papers of the Accounting Standards Division of the AICPA, and Practice Alerts of the AICPA SEC Practice Section Professional Issues Task Force.

Employee Stock Options

As noted in last year's Alert, stock options are an important accounting-related area for your high-tech clients. Knowledgeable workers are the prime assets of high-tech businesses and are the key to wealth creation. Accounting for their compensation sometimes raises difficult accounting issues if high-tech companies include stock options in employee compensation packages. High-tech companies grant stock options to essential employees to attract, motivate, and retain them, in addition to granting stock options, awards of stock, or warrants to consultants, contractors, vendors, lawyers, finders, lessors, and others. Issuing equity instruments makes a lot of sense, partly because of the favorable accounting treatment and partly because the use of equity conserves cash and generates capital.

The accounting for employee stock options has received renewed attention in recent months. Several major U.S. companies have announced their intentions to change their method of accounting for employee stock options to an approach that recognizes an expense for the fair value of the options granted in arriving at reported earnings. Recognizing compensation expense relating to the fair value of employee stock options granted is the preferable approach under FASB Statement No. 123, *Accounting for Stock-Based Compensation*. It also is the treatment advocated by an increasing number of investors and other users of financial statements.

Due to these developments, as well as the increased scrutiny from the press, Congress, regulators, and others, the FASB is currently working on a project that would affect the way companies account for employee stock options. The FASB has recently issued an exposure draft, *Accounting for Stock-Based Compensation—Transition and Disclosure*, which would amend FASB Statement No. 123.

See the discussion of this exposure draft in the "On the Horizon" section of this Alert.

Currently, there are two permissible methods of accounting for employee stock options: APB Opinion No. 25, *Accounting for Stock Issued to Employees*, which uses the intrinsic value method, and FASB Statement of Financial Accounting Standards No. 123, which uses the fair-value method. Most e-businesses choose APB Opinion No. 25, which is easier to apply.

Stock options granted to consultants, contractors, and nonemployees for services rendered or goods purchased must be accounted for in accordance with FASB Statement No. 123. Accordingly, companies must use the fair value method, not the intrinsic value method. EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other than Employees for Acquiring, or in Conjunction with, Selling Goods and Services*, offers guidance in applying FASB Statement No. 123 to these transactions.

With the downturn in share prices of many e-businesses continuing throughout 2002, the stock options previously granted to many essential employees may now have lost much of their value. To retain these employees, many companies may reprice the options. FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, is an interpretation of APB Opinion No. 25, and provides that "if the exercise price of a fixed stock option award is reduced, the award shall be accounted for as variable from the date of the modification to the date the award is exercised, is forfeited, or expires unexercised." The EITF also addressed the repricing issue in EITF Topic No. D-91, *Application of APB Opinion No. 25,* Accounting for Stock Issued to Employees, *and FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, to an Indirect Repricing of a Stock Option.*

FASB Interpretation No. 44 indicates that any modification or sequence of actions by a grantor to directly or indirectly reduce the exercise price of an option award causes variable accounting for the repriced or replacement award for the remainder of the award's life. The change from a fixed to a variable plan triggers the requirement to record income statement charges (or credits) at each reporting date. So, although the intrinsic value of the option may be zero at the repricing (or modification) date, from that date until the final exercise (or expiration or forfeiture), the company must report an expense or reversal of that expense even though the options are not vested. This expense is the difference between the fair value of the shares at each balance-sheet date and the exercise price.

The change in accounting triggered by repricing requiring compensation to be recorded has no effect on cash flow. However, it may reduce net income and earnings per share. Management should be made aware of the consequences of making any modification to their option plans and outstanding options and the financial statement impact of giving equity instruments to nonemployees.

Asset Impairment

High-technology products are susceptible to rapid obsolescence. Long-lived assets used by enterprises involved in the manufacture of such products may require significant retooling to retain their usefulness. In some cases, these assets may not lend themselves to modification and could be rendered obsolete. Additionally, the high-tech industry has experienced a spurt of merger and acquisition activity. The elimination of duplicate functions, which typically accompanies a merger or acquisition, may affect the carrying amount of certain assets. These are just a few of the examples of the instances in which the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 144 may need to be applied.

FASB Statement No. 144 provides the primary guidance on accounting for the impairment of long-lived assets. In general, the accounting for the impairment of long-lived assets depends on whether the asset is to be held and used or held for disposal.

Long-Lived Assets Held and Used

Long-lived assets held and used should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred. Conditions or events such as the following may indicate a need for assessing the recoverability of the carrying amount of assets:

- A dramatic change in the manner in which an asset is used
- A reduction in the extent to which an asset is used
- Forecasts showing lack of long-term profitability
- A change in the law or business environment
- A substantial drop in the market value of an asset

If events and circumstances indicate that impairment may exist, the entity is required to estimate the future cash flows expected to result from the use of the asset and its eventual disposition. An asset is deemed to be impaired if its carrying amount exceeds the sum of the expected future cash flows (undiscounted and without interest charges) from the asset. The impairment is measured as the amount by which the carrying amount exceeds the fair value of the asset. After an impairment is recognized, the reduced carrying amount of the asset should be accounted for as the new cost of the asset and depreciated over the remaining useful life. Restoration of previously recognized impairment losses is prohibited.

Lack of an asset-impairment evaluation system may indicate a material weakness in an entity's internal controls. Further, a lack of documentation generally increases the extent to which you must apply professional judgment in evaluating the adequacy of management's writedowns.

Long-Lived Assets to Be Disposed of by Sale

Long-lived assets to be disposed of by sale (assets for which management has committed to a plan of disposal) should be reported at the lower of the carrying amount or fair value, less costs to sell. Subsequent revisions to fair value less costs to sell should be reported as adjustments to the carrying amount of the asset to be disposed of. However, the carrying amount may not be adjusted to an amount greater than the carrying amount of the asset before an adjustment was made to reflect the decision to dispose of the asset.

Although some long-lived assets might have previously been subject to APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, FASB Statement No. 144 amended APB Opinion No. 30. The provisions of FASB Statement No. 144 apply to all long-lived assets. Therefore, gains or losses on disposal of a discontinued operation are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur. (See the "New Accounting Pronouncements and Other Guidance" section of this Alert for additional information related to this Statement.)

Assets to Be Disposed of Other Than by Sale

Assets that are to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spin-off are to be considered as held and used until they are disposed of. If the asset is to be abandoned, the depreciable life is revised in accordance with APB Opinion No. 20, *Accounting Changes*. If the asset is to be exchanged for a similar productive asset or distributed to owners in a spin-off, an impairment loss is to be recognized at the date of exchange or distribution, if the carrying amount of the asset exceeds its fair value at that date.

The provisions of FASB Statement No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early implementation encouraged. The provisions of the Statement generally are to be applied prospectively.

Research and Development Costs

As noted in last year's Alert, ongoing innovation is the heart of competition in the high-tech industry and is required for survival. Consequently, most high-tech companies devote a substantial portion of their resources to research and development (R&D) activity. According to paragraphs 8(a) and 8(b) of FASB Statement No. 2, *Accounting for Research and Development Costs*:

> Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service.
>
> Development is the translation of research findings or other knowledge into a plan or design for a new product or process...whether intended for sale or use.

High-tech management may reduce net loss or increase earnings by capitalizing R&D costs, which are significant for many companies in the high-technology industry. However, FASB Statement No. 2, as interpreted by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, prohibits capitalization and requires R&D to be expensed when incurred, except for acquired R&D with alternative future uses purchased from others. In addition to the requirement to expense internal R&D, FASB Statement No. 2 requires disclosure in the financial statements regarding the total amount of R&D costs charged to expense.

Some high-tech companies acquire their assets through mergers and acquisitions. One purpose of these business combinations is to acquire in-process R&D. You may need to hire a technology specialist to determine which acquired technology objects have alternative future uses. For clients with technology with alternative future uses, you should verify that they are properly valued and capitalized.

The AICPA Practice Aid *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (product no. 006609kk) may be helpful in valuing these intangible assets. The Practice Aid is available from the AICPA Order Department at (888) 777-7077 or go online at www.cpa2biz.com.

New Auditing and Attestation Pronouncements and Other Guidance

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter, Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	*Generally Accepted Auditing Standards*
SAS No. 96	*Audit Documentation*
SAS No. 97	*Amendment to Statement on Auditing Standards No. 50,* Reports on the Application of Accounting Principles
SAS No. 98	*Omnibus Statement on Auditing Standards—2002*
SAS No. 99	*Consideration of Fraud in a Financial Statement Audit*
SAS No. 100	*Interim Financial Information*
SOP 02-1	*Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*
SSAE No. 11	*Attest Documentation*
SSAE No. 12	*Amendment to Statement on Standards for Attestation Engagements No. 10,* Attestation Standards: Revision and Recodification
SQCS No. 6	*Amendment to Statement on Quality Control Standards No. 2,* System of Quality Control for a CPA Firm's Accounting and Auditing Practice
Audit Guide	*Service Organizations: Applying SAS No. 70, as Amended*
Audit and Accounting Guide	*Audits of State and Local Governments* (GASB 34 Edition)
Auditing Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Auditing Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"

Auditing Interpretation No. 12 of SAS No. 1	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"
Auditing Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Related-Party Toolkit	*Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors*
Practice Alert No. 02-1	*Communications With the Securities and Exchange Commission*
Practice Alert No. 02-2	*Use of Specialists*
Practice Alert No. 02-3	*Reauditing Financial Statements*
Practice Aid	*Fraud Detection in a GAAS Audit*
Practice Aid	*New Standards, New Services: Implementing the Attestation Standards*
Practice Aid	*Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel*
Booklet	*Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users*

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316); amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended. The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1 (AU sec. 110.02).[3] However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.[4]

The following is an overview of the content of SAS No. 99, with references to paragraphs in the new fraud standard:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs 5 through 12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph 13.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of

3 The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). For those illegal acts that are defined in that Statement as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]), or fraud.

4 Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards. Chapter 1, "Attest Engagements," of Statements on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), and Statements on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

adopting an appropriate mindset of professional skepticism. (See paragraphs 14 through 18.)

- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by:

  1. Inquiring of management and others within the entity about the risks of fraud. (See paragraphs 20 through 27.)
  2. Considering the results of the analytical procedures performed in planning the audit. (See paragraphs 28 through 30.)
  3. Considering fraud risk factors. (See paragraphs 31 through 33, and the Appendix, "Examples of Fraud Risk Factors.")
  4. Considering certain other information. (See paragraph 34.)

- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs 35 through 42.)

- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs 43 through 45.)

- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence (see paragraph 46). The section requires the auditor to respond to the results of the risk assessment in three ways:

1. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned (See paragraph 50.)
2. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed (See paragraphs 51 through 56.)
3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls (See paragraphs 57 through 67.)

- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs 68 through 74.) It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs 75 through 78.)
- *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others. (See paragraphs 79 through 82.)
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements. (See paragraph 83.)

SAS No. 99 also includes an Exhibit, "Management Antifraud Programs and Controls: Guidance to Help Deter, Detect, and Prevent Fraud," which has been developed to assist auditors in obtaining an understanding of programs and controls established by management to mitigate specific risks of fraud, or that otherwise help to prevent, deter, and detect fraud. SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

The AICPA has published a fraud Practice Aid titled *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide*. The Practice Aid includes topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids, such as specialized industry fraud risk factors, common frauds, and extended audit procedures. Auditors should be on the lookout for this new publication.

Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide*

In connection with the issuance of SAS No. 99, the AICPA is issuing a Practice Aid to help practitioners implement the new fraud guidance. The practice aid is entitled *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613). The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Characteristics of fraud
- Understanding the new fraud SAS
- Best practices
- Practice aids, such as:
  - Specialized industry fraud risk factors
  - Common frauds and extended audit procedures

The Practice Aid represents valuable guidance in helping practitioners understand and implement SAS No. 99.

New Accounting Pronouncements and Other Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	*Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*
FASB Statement No. 146	*Accounting for Costs Associated with Exit or Disposal Activities*
FASB Statement No. 147	*Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 71 and 144 and FASB Interpretation No. 9*
FASB Interpretation No. 45	*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
SOP 01-5	*Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*
SOP 01-6	*Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*
Technical Practice Aid	*Software Revenue Recognition*
Questions & Answers	*FASB Statement No. 87, Employers' Accounting for Pensions*

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org.

FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*

This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*.

The FASB decided to address the accounting and reporting for costs associated with exit or disposal activities because entities increasingly are engaging in exit and disposal activities and certain costs associated with those activities were recognized as liabilities at a plan (commitment) date under Issue 94-3 that did not meet the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements.*

The principal difference between this Statement and Issue 94-3 relates to the Statement's requirements for recognition of a liability for a cost associated with an exit or disposal activity. This Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost as defined in Issue 94-3 was recognized at the date of an entity's commitment to an exit plan. A fundamental conclusion reached by the FASB in this Statement is that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, this Statement eliminates the definition and requirements for recognition of exit costs in Issue 94-3. This Statement also establishes that fair value is the objective for initial measurement of the liability.

The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

New Framework for the Audit Process

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB issued an exposure draft in November 2002, which proposes to add or amend a number of auditing standards. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

Some of the more important changes to the standards that are proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent and control risks and eliminate the "default" to assess either of these risks at the maximum.

- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor uses the audit risk model.

In connection with this major initiative, the ASB and the International Auditing and Assurance Standards Board (IAASB) have formed a joint task force to develop joint standards addressing the risk assessment process. These standards will represent a significant step toward converging U.S. and international auditing standards.

You should keep abreast of the status of this project and exposure draft, inasmuch as the proposed SASs will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

Proposed AICPA SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, and proposed FASB Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activ-*

ities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73, are being issued simultaneously for public comment.

Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued during the first half of 2003.

Exposure Draft on Liabilities and Equity

The FASB has issued an exposure draft of a proposed Statement *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. This proposed Statement would establish standards for issuers' classification in the statement of financial position of financial instruments with characteristics of liabilities, equity, or both. It would require that an issuer classify liability components and equity components of a financial instrument separately. This proposed Statement would prohibit the presentation of items between the liabilities section and the equity section of the statement of financial position. The FASB also issued an exposure draft of a proposed amendment, titled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*, which would amend FASB Concepts Statement No. 6, *Elements of Financial Statements*. This proposed amendment to

FASB Concepts Statement No. 6 would revise that definition to also include as liabilities certain obligations that require or permit settlement by issuance of the issuer's equity shares and that do not establish an ownership relationship. The objective of the project is to improve the transparency of the accounting for financial instruments that contain characteristics of liabilities, equity, or both. Final Statements are expected to be issued during the fourth quarter of 2002.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit Guide *Consideration of Internal Control in a Financial Statement Audit* (product no. 012451kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2002* (product no. 009894kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)

- Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (publication by the end of 2002)
- General *Audit Risk Alert—2002/03* (product no. 022333kk)
- Audit Risk Alert *Compilation and Review 2002/03* (product no. 022303kk)
- Audit Risk Alert *E-Business Industry Developments—2002/03* (product no. 022323kk)

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditor's reports, checklists, and engagement letters; management representation letters; and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, all Audit and Accounting Guides, all Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential online service, go to www.cpa2biz.com.

Educational Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737082kk (VHS tape/manual) and 187082kk (video)). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.
- *Fair Value Accounting for Hedge Transactions* (product no. 735182kk). This course helps you understand GAAP for

derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.

- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731810kk (text) and 181810kk (video); available December 31, 2002). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.

- *Auditing for Internal Fraud* (product no. 730237kk). This course provides an auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.

- *Identifying Fraudulent Financial Transactions* (product no. 730243kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.

- *Independence* (product no. 739058kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.

- *SEC Reporting* (product no. 736747kk). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.

- *E-Commerce: Controls and Audit* (product no. 731551kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee ($95 for members and $295 for nonmembers) provides unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

The Practitioner's Update (product no. 738450kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

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This Audit Risk Alert replaces *High-Technology Industry Developments—2001/02*. *High-Technology Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to *ymishkevich@aicpa.org* or write to:

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INFORMATION SOURCES

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com
AuditNet	Electronic communications among audit professionals	www.cowan.edu.au/mra/home.htm
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
Double Entries	A weekly newsletter on accounting and auditing around the world	www.csu.edu.au/lists.anet/ADBLE-L/index.html
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	www.cybersolve.com/tools1.html
FedWorld. Gov	U.S. Department of Commerce-sponsored site providing access to government publications	www.fedworld.com

Name of Site	*Content*	*Internet Address*
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine that uses a user-friendly question format. Provides simultaneous search results from other search engines as well (e.g., Excite, Yahoo, AltaVista)	www.askjeeves.com
Vision Project	Information on the profession's vision project	www.cpavision.org/horizon
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	www.kentis.com/ib.html
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org

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